Internal Revenue Service

# memorandum

CC:TL-N-3314-90
Br1:JLRood

date: FEB 22 1990

to: Theodore J. Kletnick
International Special Trial Attorney CC:NA

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

We are writing to you in response to your request for tax litigation advice date February 5, 1990, and to confirm our oral response of February 15, 1990.

## ISSUE

Whether the Internal Revenue Service may enter into a closing agreement whereby the [redacted] ("[redacted]") would be permitted to utilize GAAP hedge accounting.

## CONCLUSION

We recommend against entering into a closing agreement whereby [redacted] would be permitted to utilize GAAP hedge accounting.

## FACTS

This memorandum incorporates the facts as stated in the attached tax litigation advice dated October 3, 1988, to Ken Jones.

## DISCUSSION

In the attached tax litigation advice we recommended not entering into a closing agreement permitting [redacted] to use GAAP hedge accounting. Our recommendation remains unchanged.

The recognition of gain or loss is determined by statute. I.R.C. § 1001(c) provides that the entire amount of gain or loss on a sale or exchange of property shall be recognized. Section 165(a) further provides that there shall be allowed as a deduction any loss sustained during the taxable year, not compensated for by insurance.

In Smith v. Commissioner, 78 T.C. 350, 376-78 (1982), the Tax Court held that a closed and completed transaction occurs for purposes of section 165(a) when a futures contract is closed out even though another contract is simultaneously entered into. See also Corn Products Refining Co. v. Commissioner, 16 T.C. 395 (1951), aff'd, 215 F.2d 513 (2d Cir. 1954), aff'd on another issue, 350 U.S. 46 (1955).

In Cottage Savings Association v. Commissioner, 90 T.C. 372 (1988), a savings and loan institution entered into reciprocal sales and purchases of loan participations with unrelated savings and loan institutions. The transfers produced losses because they were made at then current fair market values, which were substantially below the taxpayer's bases in the loans. The Federal Home Loan Bank Board did not permit recognition of the claimed losses for regulatory accounting purposes. The Tax Court held that the losses were deductible in the year the transfers were made even though the taxpayer received similar loan participations as consideration for the sales. The court stated that it relied on section 1001 in the context of the tax laws and the tax precedents rather than on regulatory or GAAP accounting principles. It further stated that under section 165(a) losses sustained during a taxable year are deductible in that year. See also Federal National Mortgage Association v. Commissioner, 90 T.C. 405 (1988). Similarly, we believe that sections 1001(c) and 165(a) require recognition of [redacted]'s losses in the taxable years in which the futures contracts were closed out.

You indicated that GAAP hedge accounting clearly reflects income under section 446(b). We are hesitant to permit the accounting industry to dicate that an accounting method which might be acceptable for finanical accounting is also a proper method for tax purposes, especially when the Service does not believe such a method clearly reflects income. Moreover, FAS 80 appears to apply an unclear and unadministrable standard. The FAS requires a high correlation of changes in the market value of the futures contract and the interest expense associated with the hedged item so that the former will substantially offset changes in the latter. If the futures contract is for an item different than the item hedged, it can qualify as a hedge provided there is a clear economic relationship between the prices of the two items and a high correlation is probable. We anticipate that problems will arise in defining such terms as "substantially offset" and "high correlation".

Notice 89-21, 1989-1 C.B. 651, which discusses the treatment of a lump-sum payment received under a notional principle contract, is distinguishable. The Service utilized section 446(b) in the Notice because such a lump-sum payment is not received in the sale or exchange of an asset. The payment is based on a notional amount rather than on an actual financial instrument. In other words, it is simply an advance payment.

Moreover, the Tax Court recently refused to apply the Notice to other types of advance payments. See Continental Illinois Corporation v. Commissioner, T.C. Memo. 1989-636.

[redacted] argues that not only does Notice 89-21 permit GAAP hedge accounting, but Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968), AOD-17103 (Sept. 17, 1970), also permits such treatment. In Artnell, the Seventh Circuit held that where income received relates to events that will occur over a fixed schedule in future periods, income recognition may be deferred until the events occur. The Service acquiesced in result only in Artnell because the same result would have occurred had Rev. Proc. 71-21, 1971-2 C.B. 549, been applied. The Service does not follow the fixed event exception created by Artnell. Moreover, Artnell deals with advance payments rather than with closed and completed transactions.

[redacted] further argues that Treas. Reg. § 1.451-5 and Rev. Proc. 71-21 override section 1001(c) based on section 446(b). First, the Service does not rely on section 446(b) in either of these pronouncements. They simply represent limited administrative relief from the rigidness of the advance payment rule. Second, both deal with advance payments rather than with closed and completed transactions.

Finally, even though entering into a closing agreement with [redacted] theoretically will not bind the Service to treat other taxpayers similarly, other taxpayers will allege that the Service is being inconsistent by not entering into similar closing agreements with them.

If you have any questions, contact Joan Rood at FTS 566-3442.

MARLENE GROSS

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Attachment:
Tax Litigation Advice dated October 3, 1988